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Abstract

The Government of Kenya has recently begun to re-emphasize the goal of rapid economic growth. Senior policy makers have been concerned about the growth-inhibiting effects of the over-valuation of the real exchange rate. This paper considers whether the real exchange rate has been a major constraint on growth in Kenya. Evidence suggests that there has been some real over-valuation. Nonetheless, the factors holding back growth lie elsewhere. The economy is still unstable, the budget is chronically in deficit, policy reform is subject to delays and reversals, and questionable governance undermines investor confidence. Action to reduce the real over-valuation of the exchange rate will contribute to higher rates of economic growth only if it is part of a comprehensive, sustained effort to fully reform the economy.

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1. Introduction

Official attention in Kenya has been shifting to the actions needed to sharply raise the rate of economic growth\(^1\). The National Development Plan 1997 to 2001 presumes that real GDP will grow at 5.9 percent\(^2\). The Sessional Paper No. 2 of 1996 projects that per capita GDP in dollars will increase during "phase one" (1995 to 2006) by 4.3 percent per annum. During “phase two” (2007 to 2020) that growth rate is expected to rise from 5.8 percent to 9 percent per annum\(^3\). In its “debt sustainability” scenario, which extends to the year 2015, the International Monetary Fund (IMF) assumed annual real GDP growth of 5 to 6 percent\(^4\). Similar growth rates appear in the “macroeconomic framework” which is the basis of Kenya’s Enhanced Structural Adjustment Facility with the IMF over the period 1996 to 1998\(^5\).

The need for faster growth in Kenya has become increasingly urgent. Over the last few years, the growth performance has been especially poor. For instance, from 1990 to 1996 inclusive, real average GDP rose by 2.7 percent per annum, implying that real per capita GDP fell. Since Kenya undertook a wide range of growth-promoting reforms during this period, such an outcome was disappointing, and unexpected. Many reasons have been given -- drought, fluctuating export prices, the uncertainty associated with multi-party elections, and the suspension of donor assistance. More recently, official attention has focused on the potential growth-inhibiting effects of the exchange rate, which is widely seen to be over-valued. Some senior policy makers have been concerned that their efforts to liberalize the foreign exchange and financial markets may be hampering Kenya’s growth prospects. The recent turmoil in those markets has heightened that concern.

This paper examines whether movements in the exchange rate have been a major factor preventing the emergence of rapid economic growth in Kenya. The paper is arranged as follows. Section 2 discusses the relationship between the exchange rate and economic growth. Section 3 examines why growth has been low in Kenya. Section 4 suggests changes in macroeconomic management which would help raise the rate of economic growth. Section 5 has concluding comments.

2. Exchange Rates and Economic Growth

   a. Historical Background

Large amounts of historical evidence (and practical experience) from both developed and developing economies highlight the importance of an "appropriate" real exchange rate for sustained economic growth. Britain's disastrous experiment in re-establishing its pre-WW1 parity with gold in the mid-1920's is a sobering reminder of the growth-sapping and employment-destroying effects of deliberately retaining an over-valued real exchange rate\(^6\). The delay in economic recovery of the "gold bloc" countries, which continued to maintain an over-valued link to gold during the 1930s, underscores the point\(^7\).

Closer to the present, members of the European Community/Union have encountered several bouts of severe exchange rate mis-alignment. For example, there was intense pressure on the
French Franc in 1967/69 and both the pound and lira collapsed in 1992. The subsequent instability in international financial markets disrupted growth. The recent attempts by European economies to meet the debt and deficit criteria for monetary union have also had a dampening effect on growth. Indeed, the slow growth and persistently high rates of unemployment throughout Europe, point to chronic misalignment of key European exchange rates.

Mexico's spectacular collapse in 1994, with its associated "tequila effect", and the recent exchange market problems in Asia, are clear evidence of the need for prudent economic management. Governments need to pay far more attention to the coherence between their macroeconomic and exchange rate policies than many of have been disposed to.

An interesting feature of these (and other) examples is that the problems (though not their timing) which forced major policy changes should have been expected. They all resulted from attempts by the various governments to avoid policies (such as devaluation or domestic deflation) which participants in the foreign exchange market had concluded were inevitable. Furthermore, all of the incidents were exceedingly disruptive, and ultimately extremely costly.

Empirical analyses in Sub-Saharan Africa (SSA) over the last decade confirm these findings, especially the negative effects on growth of an over-valued real exchange rate. This work has additional insights. One is that macroeconomic instability (accompanied by high rates of inflation) has been a far more potent source of stagnation and decline than exchange rate misalignment. Many African governments have compounded the instability by postponing adjustment through external loans, and when those declined, by attempting to “finance” the macroeconomic imbalances through domestic money creation. This behavior, which has many historical precedents, has destroyed any prospect of sustained economic growth and development.

It is useful to highlight the direct links between exchange rates and economic growth. But, most of the important macroeconomic effects are indirect. Of particular note is the interaction among exchange rates, inflation, and economic growth. A typical problem is created by high and rising inflation (due, most often, to rising budget deficits) within the context of a sluggishly adjusting nominal exchange rate, which is being “managed” by the central bank in order to “maintain stability”. The resulting real over-valuation of the exchange rate impedes export growth and creates the uncertainty and loss-avoiding behavior (such as capital flight and currency substitution) which undermines investment and growth.

In both theory and practice, there is a close relationship between movements in the exchange rate and the rate of inflation. The purchasing power parity theory of exchange rate determination, which is based on the law of one price, expresses the change in the exchange rate as a function of the difference between the (appropriately weighted) change in "world" prices and the change in domestic prices. The monetary theory of the balance of payments, which relates movements in international reserves (if exchange rates are fixed) or the exchange rate (if it is floating) to shifts in relative demand for and supply of money, yields a similar functional relationship.

Because the nominal exchange rate (i.e., the local price of foreign exchange) is so readily observable it is a sensitive policy indicator. Yet, economic managers need to focus on trends in
the real exchange rate. The real exchange rate is defined as the ratio of the price of tradables to the price of non-tradables. The former can be estimated as the product of the nominal exchange rate and a relevant "world" price index. The latter is usually represented by consumer prices or an index of labor costs. From this definition, the real exchange rate will move if: (i) the nominal exchange rate changes; or (ii) world prices and local prices change at different rates.

An overvalued real exchange rate represents a persistent mis-alignment of prices between a particular country and the rest of the world. Such a mis-alignment has an impact on the pattern and level of production, the allocation and level of expenditure; the distribution and level of factor payments; the composition and size of trade flows; the levels of international reserves and external debt; and (in more extreme cases) the emergence of parallel foreign exchange markets, currency substitution, and capital flight. Persistent real overvaluation also seriously erodes business and consumer confidence which, in turn, affects the rate of savings and investment.

b. SSA and Real Exchange Rates

The macro-economic effects of real exchange rate overvaluation are evident whether SSA is treated as a single economic unit, or each country is taken separately.

Treating SSA as a single economic unit reveals clear evidence of a system which has a chronically mis-aligned real "exchange rate": the external debt is unserviceable; aggregate income per capita has collapsed despite the rapid growth of the labor force; exports have declined; SSA’s share in world export markets has fallen; import compression has been severe, even though official inflows of concessional finance have been large; private capital inflows have been low; currency substitution has been widespread; exchange controls have not prevented massive capital flight; and parallel foreign exchange markets have flourished even though they have been illegal in most countries.

Action to remedy the chronic over-valuation of the real exchange rate would not overcome these economic problems in SSA. But, any program which sought to resolve SSA’s economic difficulties has to include a substantial real depreciation of the exchange rate. Some efforts are underway. From the early 1980s, an increasing number of governments in SSA have been promoting economic reform. Although some progress has been made, major mis-alignments of the (aggregate) real exchange rate persist. The stock of foreign debt is still rising; private foreign investors continue to find opportunities outside Africa more attractive and markedly less risky; growth remains sluggish despite some recent improvement; and savings rates are substantially below investment rates. Moreover, due to the persistence of large budget deficits, inflation in SSA is now substantially higher than in other regions of the world. Since few governments in SSA can resist the temptation to manipulate their nominal exchange rates, this reinforces the persist real exchange rate over-valuation.
c. The Situation in Kenya

Macroeconomic trends in Kenya over the last two decades have been similar to those in SSA. The only notable differences are that Kenya's debt to GDP and debt service ratios are below the SSA average, especially when allowance is made for South Africa's large GDP and low external debt. On all other counts -- high rates of inflation, chronic deficit financing, dependence on foreign aid, declining real per capita income, delayed policy reforms, and so on -- Kenya's performance mirrors that of SSA. Furthermore, Kenya’s real exchange rate has been significantly overvalued. Together, these factors have led to slow growth in Kenya.

The recent economic data (1990 to 1996) confirm this. Table 1 shows the following:

- The nominal exchange rate has been relatively stable since 1993;
- Due to differential inflation between Kenya and the rest of the world, the real exchange rate has appreciated, especially since 1993;
- The rate of inflation has been generally high and variable;
- Nominal interest rates have experienced sharp fluctuations especially since 1991;
- The gap between nominal interest rates and inflation (a guide to trends in real interest rates) only became solidly positive in 1995 and 1996;
- The growth rate of the money supply (measured as M2) has been well above any actual or expected increase in real output over the whole period;
- The fiscal deficit as a percentage of GDP (with and without grants) has been large;
- Exports of goods and services have increased rapidly, but the trend in imports has been such that all additional export proceeds have been spent;
- Both the absolute and relative size of the current account deficit on the balance of payments has been large, thereby adding to Kenya's already large external debt burden;
- Domestic savings have averaged 19.6 percent of GDP since 1990;
- Domestic investment has averaged 20.9 percent of GDP since 1990;
- The dollar value of Kenya's GDP has fluctuated significantly although due to the overvalued exchange rate it has risen;
- Based on local estimates of constant price output, the real growth of GDP has been on the order of 2.7 percent since 1990. This is just below the average rate of population increase.

Over the last two years there has been some evidence of improvement -- the budget deficit is lower, real interest rates are positive, investment has risen, and real growth is higher. When the record is viewed more broadly, however, there are serious doubts that the improvements will be sustained. The IMF, for example, confirmed those doubts when its staff did not recommend that the recent review of the 1996-1998 Enhanced Structural Adjustment Facility be concluded. Whether these doubts triggered the recent financial turmoil is debatable. The civil unrest added to the economic uncertainty which was compounded by the spill-over effects of the “blow-out” in some of the more precarious Asian financial markets.
For Kenyan officials to blame external factors, however, would be missing the point. At the macro-economic level, Kenya’s policymakers have been operating with no effective margin for error for years. Indeed, the macroeconomic data show that the economy has never been fully stable. The data in Table 1 highlight some of the main problems -- money supply growth has been high, the budget deficit is large, imports generally exceed exports by a wide margin and, despite levels of external debt which cannot be serviced without substantial donor assistance, Kenya as a nation continues to dissave.

Kenya’s chequered history of reform and the recent hesitant approach to macroeconomic management, based apparently on the belief that the economy can be “eased” towards macroeconomic stability, is not a viable strategy for rapid growth. Even before the recent financial panic, the government’s approach to policy would not have stabilized the economy over the medium term. It was clearly reflected in the behavior of local and foreign investors. Without stability, which is widely seen to be enduring, sustained increases in the rate of growth will not materialize.

3. Why Has Economic Growth Been so Low in Kenya?

Numerous micro-economic and institutional factors have undermined growth in Kenya. Other factors such as drought have been important. For rapid, sustained growth to emerge in Kenya, these constraints will have to be addressed. Yet, in order to begin creating the setting conducive to the revival of economic growth a number of issues related to macroeconomic management require attention. The most important follow:

- The economy is too dependent on foreign aid and there is no evident commitment by either the donors or the government to change this;
- The public sector is too large, too intrusive, too inefficient (and, for many, too corrupt) to generate the conditions for rapid growth;
- Public and private savings are too low to support the rate of productive investment needed to achieve high rates of growth;
- Macro-economic policy has been too inconsistent to generate the broad-based changes in investor behavior which are vital if capital inflows are to be attracted and retained; and
- The persistence of relatively large budget deficits severely undermines the ability of the central bank to manage the public debt in ways that permit an exchange rate policy that supports the rapid and sustained increase in productive investment.

Each of these points is discussed in turn.

Aid Dependence. Several episodes over the last decade have demonstrated the degree to which Kenya has become, and remains, overly dependent on foreign assistance. The economic repercussions of the suspension by donors of aid flows in November 1991 due to concerns about governance (especially the lack of progress towards multi-party democracy) revealed how vulnerable the economy was to shifts in donor priorities. During that time, the exchange rate
depreciated sharply as uncertainty increased and foreign inflows declined. Kenya's improved standing with the international community following the December 1992 elections led to a rise in donor flows and a marked firming of the Kenya shilling.

These exchange rate fluctuations, especially the appreciation which occurred, were not been consistent with the movement towards a local cost structure which will support sustained growth and development. While the government avoids taking the steps needed to reduce its dependence on aid flows, the economy will remain vulnerable. Moreover, while such dependence persists, the exchange rate will be determined largely by donor flows (and shifts in market sentiment which is associated with changes in those flows) and not by the capacity of the Kenyan economy to compete within an international setting.

So far, there are no examples of any economy, anywhere, which has grown and developed rapidly on a sustained basis while relying on large amounts of foreign assistance. It seems safe to predict that Kenya will not be the first!

Large, inefficient, public sector. The Government of Kenya collects and spends roughly 30 percent of GDP. The majority of government expenditure is for recurrent purposes, little of which is productively used. Of the resources which might potentially enhance productivity, misallocation and “leakages” are common. There are perennial complaints about the deterioration of the physical infrastructure which implies that resources devoted to maintenance are ineffectively used.

Government control over such a large portion of national expenditure undermines efficiency. There are difficulties on both sides of the account. Raising large amounts of revenue requires the use of many highly distortionary taxes. Spending such a large share of national income creates further imbalances. For instance, the wage bill is disproportionately large relative to the amounts devoted to operations and maintenance and public investment.

These distortions are compounded by the operations of the public enterprises, few of which are productive or generate economic surpluses. Indeed, the efforts to “ commercialize” and “ privatize” these enterprises has been prompted by their collective inefficiency.

The result is that any dynamism generated within the private sector has been largely offset by the dead weight of a public sector that taxes too much and spends what it receives too unproductively.

Low Savings and Investment. Savings have averaged slightly less than 20 percent of GDP, while investment has averaged slightly more than 20 percent of GDP. Both of these are low by historical standards in Kenya and by the standards of the rapidly growing developing countries. Based on Kenya’s average growth rate of the last decade, the investment ratio implies an incremental capital-output ratio on the order of 7. Although this datum is relatively low for SSA, it is high relative to the rest of the world with whom Kenya has to compete if it is to reduce its degree of marginalization in the world economy.
For rapid growth in Kenya, there will need to be a marked increase in the share of national income saved combined with a dramatic improvement in the efficiency with which those savings are used. One way of enhancing national savings is for the government to begin running large surpluses. This is not a new idea, but it is long over-due for implementation in Kenya (and elsewhere in Africa).57

Inconsistent Macro-economic Policy. Kenya's policy makers can point to numerous changes as milestones in economic adjustment -- progress in tax reform, a smaller civil service, some privatization, modest reorganization of the budget, widespread computerization of government operations, decentralization of (some) administrative functions, support for aspects of financial reform, and multi-party elections. The list could be extended. There is no doubt that advances, some of which might even be described as dramatic, have occurred. Nonetheless, these changes have occurred against a background of official reluctance, and a widespread resentment by senior officials of what they view as “outside interference.”59

This is the familiar problem of “policy ownership”. Senior government officials in Kenya have tended to treat economic reform as a necessary evil. There is little evidence that they are convinced that policy reform, adopted and promoted by Kenyans, will raise the rate of economic growth and improve the prospects for development for all Kenyans. This lack of conviction has been reflected in a pattern of delay and partial implementation and numerous slippages of key policy reforms. One result is continued macroeconomic imbalance.

For instance, over the last two years the macroeconomic situation has been characterized by relatively high real rates of interest (due to the Bank of Kenya's attempts to control liquidity), a sharply appreciated real exchange rate (due mainly to the knock-on effects of the resumption of foreign aid and high coffee prices), and continued rapid increase in money supply growth (due to the monetary effects of higher reserve accumulation, increased lending to public enterprises, and the budget deficit).

This combination is not sustainable. Since Kenyan policy makers do not have a reputation for prudent and timely action, asset-holders and potential investors will typically “wait and see” how the authorities proceed and when. This is the familiar “option” value of waiting. Such an option imposes few costs on asset-holders (locals can simply roll over short-dated debt, foreigners can keep their resources abroad). However, the ensuing delay have a major impact on countries, like Kenya, which depend on the recovery of investment to stimulate economic growth.

Large Budget Deficits. Despite the fact that the government has been raising revenue of close to thirty percent of GDP, this amount is still inadequate to cover its expenditure. The result has been a chronic budget deficit which has fostered high rates of domestic credit creation. This has put pressure on local prices and, with the nominal exchange rate appreciating as business uncertainty eased, donors resumed their support and export proceeds rose, added to the degree of real overvaluation of the exchange rate.

In macro-economic terms, the government's present approach to budget policy is inconsistent with the objective of raising the rate of growth in the short and medium term. (It is also
inconsistent with the effective control of inflation\textsuperscript{64}. If the government continues to command such a large share of national income, it should at a minimum ensure that the budget itself is not a source of macro-economic instability. That would require the government to generate an overall surplus so that all government expenditures are covered by available revenues. It is no comfort, as some policy makers assume, that the government is running a “primary surplus” or even a “recurrent surplus” if the overall result of government action is a net addition to domestic credit. Whether this credit has been used for roads or wages or debt service is immaterial; the net effect is that the budget has been a source of credit creation. This, in turn, has reduced the amount of credit available (at a constant real interest rate) to the private sector. However, if through other means, the government ensures that credit to the private and parastatal sector continues to rise, further pressure is added to domestic prices. In both cases, the budget itself continues to a source of instability\textsuperscript{65}.

4. A Growth-Oriented Macroeconomic Program for Kenya

   a. Improved Macroeconomic Management

If Kenya is to attain rapid, sustained rates of economic growth and development fundamental changes are required. Five dimensions of macroeconomic management are important. They are:

- the phased reduction of Kenya's aid dependence;
- the elimination of the budget deficit;
- the selective, but rapid, reduction of the size of the public sector;
- the development of a coherent approach to macroeconomic management which embraces fiscal, monetary, exchange rate, and debt management; and
- assemble a team of technical specialists whose task is to focus on achieving and sustaining rapid growth and development.

Reduce aid dependence. Because of past external support which has led to the ongoing implementation of many projects and programs, Kenya does not have the option of sharply reducing the aid it receives immediately, even if that were desirable on other grounds. Moreover, Kenya still has a large external debt over-hang that can only be rationalized (and reduced) through continued aid. Therefore, any reduction in aid dependence will need to be gradual. This should be done in a structured, time-bound way that incorporates explicit penalties for back-sliding. The main reason for reducing Kenya's dependence on aid is to eliminate the pernicious, growth-and-development-destroying gamesmanship that dominates economic management. These games are most evident when the government wants access to external resources but is unwilling to manage the economy in ways that use these (and domestically mobilized) resources efficiently. Aid dependence should also be reduced to ensure that the donors do not attempt to maintain their influence by similarly motivated games.
To begin the process of reducing aid dependence, a date would be agreed by which all significant bilateral and multi-lateral assistance above minimal (humanitarian) levels would cease. That date - no more than a decade hence -- should be close enough to focus attention on the types of adjustments required within Kenya to mobilize the resources which are needed to replace (and hopefully go well beyond) the aid flows. The date should also be far enough away to allow an orderly program of adjustment.

If the Government of Kenya were to decide that its aid dependence had to be reduced or eliminated, several immediate steps would be required. First, the government would agree to a program with donors for reducing the flow of aid. (Such a program is needed because considerable pressure for continued foreign assistance comes from the donor agencies.) Second, government officials would review and change the policies which inhibit the mobilization of resources, both domestically and abroad. An obvious example, is the “tax” on financial intermediation associated with high reserve requirements on financial institutions. Third, the main areas in which domestic resources are being used unproductively would be identified and remedies formulated and implemented. And, fourth, the government would sharply accelerate its program to disengage from the economy so that the opportunities for local and foreign investors can expand as rapidly as possible.

Eliminate the Budget Deficit. Kenya, which has a history of over-borrowing and inflation and ineffectual management cannot hope to grow and develop on a sustained basis if the government persists in running a budget deficit. Policy makers have to abandon the idea that they can “slide by” with “small” deficits. The real resources will not materialize either locally or from abroad to finance the deficit in ways that do not undermine the growth process and destabilize the economy.

The budget deficit could be eliminated in a number of ways. One would be a cash budget. If this were done, stringent measures would be needed from the start to prevent the build-up of arrears. Another approach, which has been used in Indonesia, would be for the government to forego all domestic borrowing. Any gap between government expenditure and revenue would have to be covered, in advance, by an inflow of foreign financing. Since Kenya is not in any position to borrow abroad on non-concessional terms, this would effectively eliminate deficit financing. A third approach would be for the government to take the measures needed to progressively (and markedly) raise the efficiency of public expenditure. This would reduce the amounts of resources required to "balance" the budget thereby taking pressure off the domestic credit system.

A fourth approach would be for the government to make the revenue and expenditure reforms needed to eliminate the deficit. One dimension of this would be the introduction of measures to reduce corruption in the public sector. For many years, the public sector in Kenya has gained an international reputation as being overtly corrupt. Apart from the pressure applied by the donor community, little has come from Kenya’s leadership to reduce corruption. While this situation persists, Kenya (like other African countries with similar reputations) will have difficulty gaining access to the types and amounts of long-term financial and physical investment needed to support rapid growth.
When the budget deficit is eliminated, a further objective would be to dramatically reduce government expenditure. The poor performance of the economy over the last two decades confirms that public institutions in Kenya do not have the capacity to support their current responsibilities. By eliminating or sharply downsizing many public institutions, government expenditure can be reduced to levels well below 20 percent of GDP. This will free up resources for the private sector. It will also enable the government to remove its most distortionary taxes (preferably by lowering tax rates).

Shrink the Public Sector. For years, the public sector in Kenya has been a major source of patronage, rent-seeking, corruption, and value-subtraction. Many observers have urged reform. Some action has been taken but, so far, it has been inadequate to boost growth and development.

Several principles could usefully guide the government's efforts to disengage from the economy. First, the government should eliminate subsidies to public enterprises. Those organizations which cannot operate on commercial principles should be closed. Second, the pace of privatization should be accelerated. Most governments in Africa argue that this cannot be done. This is often a delaying tactic. Moreover, the issue could be resolved by openly computing the benefits and costs of further delay.

Third, the monopoly status of particular enterprises, such as telecommunications, should be removed. Open competition should be allowed as a means of reducing costs for consumers and producers. Fourth, the government should put public sector unions on notice that their full cooperation is required in restructuring and reducing the size the public sector. One way of enforcing this approach would be for the government to set limits on its wage bill which are consistent with a reduction in the ratio of public sector wages to GDP. The unions would then be assigned the task of making the division between changes in the pay scale and changes in employment. A less convoluted solution would be for the government, which was responsible for public sector over-staffing, to shrink the public payroll to the numbers which are sustainable and consistent with efficient administration.

Consistent Approach to Macroeconomic Management. A major problem in Kenya is that policy makers have underestimated the impact of the international financial system on their capacity to formulate fiscal and monetary policy. As a matter of habit, policy makers typically begin with an assessment of local opportunities and constraints and, determining how they will respond, turn their attention to potential influence of changes in the external sector. This pattern of policy formulation and management is the reverse of what is required. The international financial system imposes constraints on monetary, fiscal, exchange rate, and debt policies that, for a small economy like Kenya, cannot be avoided and, moreover, cannot be fudged. For instance, asset-holders require internationally comparable risk-adjusted inducements to ensure that they will retain their resources in Kenya and invest them in growth-oriented projects. Thus, when Kenyan real interest rates are viewed in risk-adjusted terms it is not clear, as many local observers maintain, that these rates are “too high”.

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No investor is ever fully “locked into” a country. There are always means of moving resources abroad. Over the last two decades, it has been a common mistake made by African policy makers to ignore the dynamics of the international resource flows. In the absence of government savings, a sustained supply of investible resources can only come from locals who want to re-invest their resources, or foreigners who are willing to take advantage of existing or new domestic opportunities for investment.

Creating the setting which encourages locals to re-invest and attracts resources from abroad on a sustained basis demands that policy makers give special attention to external developments and opportunities. This requires that Kenyan policy makers ensure that their fiscal and monetary policies generate low inflation, a stable growth-inducing real exchange rate, and relatively low real interest rates. With these policies in place, Kenya would begin to have the foundation for re-generating the confidence needed to support high rates of productive investment.

Part of this policy consistency has to come from the broader setting created by the government. The tolerance of corruption which leads to the dissipation of national wealth through “deals” on aircraft and dams, the shipment of sand as gold, and the periodic killing of demonstrators adds to uncertainty. Within such a setting it is no surprise that international disturbances spill-over to the local economy as has occurred over the last few months. The basic point is that, in macroeconomic terms, Kenya has not yet created the type of policy setting which provides the degrees of freedom needed to handle major shocks. While the budget deficit remains, this freedom will be absent.

Team of Technical Specialists. Economic reform is hard work! Sustaining economic reform is even harder. No country has grown rapidly on a sustained basis by chance. A major conclusion of the work on the "East Asia Miracle" and other success stories is that rapid sustained growth requires a coherent program based on solid technical analysis, supported by a commitment to high quality management.

Experience across a range of adjusting countries, from Indonesia to The Gambia, shows that a small team of technical specialists facilitates the task of creating this program. It also helps to ensure that the leadership remains focused on the principal tasks involved in promoting and sustaining high rates of growth.

The team, which might be seen as a Technical Committee, Task Force, or a Secretariat, should consist of staff drawn from the principal economic agencies within the government. Team members should be instructed to assemble and maintain an up-to-date data base on the major economic and social variables relevant to managing the economy; conduct the types of analyses needed to move the economy onto a path of rapid growth and development; and formulate and recommend the measures needed to keep it there.

The team need not be formally structured. Indeed, the less formality involved the better. It should meet at regular intervals to monitor the economy and have the power to co-opt other officials as needed. It should also have regular briefing sessions (at least weekly) with the relevant economic policy makers which, may, depending on the issue, include the Head of State.
The existence of such a team serves several purposes. First, as a practical matter, no reform program can be kept on track without the close collaboration and cooperation of all relevant economic agencies. Forming a team which fosters this cooperation is a positive step. Second, there are many adjustment problems that can only be effectively addressed on an inter-agency basis. The team could highlight these and ensure that they are dealt with quickly and effectively. Third, the substantive improvements in data and policy-related dialogue stimulated by the team's activities would provide a firmer basis for decision making. Over time, the work of the team members can move beyond the fire-fighting efforts needed to give impetus to reform to the longer-term questions related to sustained growth and development. Fourth, the work of the team would facilitate the country's interaction with the main donor agencies such as the IMF and World Bank. An important aspect of this work would be to ensure that both the government and the donors conduct their dialogues and implement their programs using a common set of assumptions and expectations. Finally, the existence of such a team provides some assurance to potential investors and the local business community that the government is taking serious steps to improve its economic management.

b. Policy Challenges in Kenya

Even without the recent instability associated with the political and financial turbulence, the Kenyan economy has been on an unsustainable trajectory. The central bank has been seeking to stabilize the exchange rate and reduce the rate of inflation in the face of high capital inflows and the continued rapid growth in domestic credit. The attempt to sterilize part of the increase in reserve money has pushed real interest rates to levels which policy makers believe will deter investment and managers of the national budget see as sharply raising the costs of domestic debt service.

The situation in 1996 is illustrative. From January 1996 to January 1997, the shilling appreciated from K56.7=$1 to K54.7=$1. Over the same period, the growth rate of reserve money was 11.8 percent and the growth of the money supply (M2) was 23.3 percent. The overall growth of real GDP was 4.8 percent. Thus, the main monetary aggregates have been increasing at rates which are more than double the rate of increase of real output. Moreover, this was occurring at a time when, there has been uncertainty about the direction of the economy's future reforms. Due in part to this uncertainty, the income velocity of money has been high. Continued pressure on prices, interest rates, and the exchange rate has been inevitable.

The main contributing factors to the growth of the money supply were a 188 percent increase in net foreign assets and a 14.9 percent increase in net credit to the private sector and public enterprises. Over the year, the nominal interest rate held steady at around 21 percent. The stock of treasury bills outstanding increased by 40.4 percent (Ksh 23.6 billion in absolute terms) as the central bank attempted to sterilize some of the increase in liquidity. At the same time, the annualized rate of inflation rose from 6.4 percent in January 1996 to 10.9 percent in January 1997. The proximate causes were the drought which raised food prices, and the high growth rates of reserve money (and M2). As a result of these changes, the costs of other items -- rent, transport and communications, and fuel and power -- rose sharply as well.
These circumstances had the government on a "carousel". With an appreciating nominal exchange rate and annual real interest rates on the order of 12-14 percent, asset-holders have been able to buy short-term financial assets with high yield and only moderate risk. The central bank's attempts to withdraw reserve money in the face of a continuing public sector deficit have kept upward pressure on interest rates. The relatively high rate of inflation will ensure that nominal interest rates remain high. In effect, the central bank has had no means by which it might growth of reserve money without reinforcing the interest rate and exchange rate effects that contribute to the “carousel”.

The way out, of course, is for the government to begin running a large surplus. This would permit the retirement of domestic debt, taking pressure off interest rates and the exchange rate.

While the above problems of an appreciating exchange rate and high real rates of interest are typical of any transition from high to low inflation, the situation in Kenya is jeopardized by the continued high growth of reserve money and M2. Indeed, such pressures make any "transition" less likely. As a first step in moving towards a growth-oriented program, the government should take immediate steps to eliminate the budget deficit and prevent further losses among the public enterprises.

In support of such a program, several other steps are necessary.

Kenya should not attempt to re-fix or "manage" the exchange rate. The Central Bank of Kenya lacks the capacity to do either in a way that will prevent long-term damage to growth. Indeed, the recent changes in the exchange rate demonstrate that Kenya has no direct means of defending itself against such instability. It should be noted that the countries which have “weathered the financial storm” -- Hong Kong, Korea, Singapore -- have approaches to macroeconomic management which, as a matter of design, provide the respective countries with some flexibility.

In Kenya, the government and the central bank should work closely to determine a growth path for reserve money which will support the objectives of high economic growth, low inflation, and a growth-inducing real exchange rate. Currently, the growth of reserve money has been subject to the limits determined by the IMF. Since the IMF program is based on real GDP growth of 5 to 6 percent over the next several years, the financial program needs to be reworked to determine the combination of monetary growth, public sector surplus, foreign reserve accumulation, and inflation that are consistent with a substantially higher rate of growth of real GDP.

The government should avoid any confidence-destroying changes in policy. If a change in the direction of policy proves necessary, it should be openly and broadly discussed so that none of the major participants and local asset-holders is "surprised". In this way, the government will to begin to develop a reputation for consistent and responsible policies that are transparently designed to achieve high rates of economic growth.

As a complementary measure the central bank has to continue improving its supervision of the financial system and begin to sharply reduce the level of required bank reserves. The cash ratio
for commercial banks and non-bank financial institutions is 18 percent and the minimum liquidity ratio is 25 percent. The reserve ratios for mortgage finance companies and building societies are similar. The size of these ratios represents a large tax on financial intermediation and hinders financial deepening. Through cooperation, the central bank and the government could substantially reduce these ratios.

So that the government remains abreast of these (and other relevant) issues, the reform effort has to be properly monitored and managed. One approach, noted above, is the assembly of an inter-agency technical committee which is assigned these responsibilities. Whether such a committee (or team) could function effectively in Kenya is a matter of judgement. Irrespective of the mechanics involved, the main point is that the country’s economic policies need to be based on sound technical analysis, effectively implemented, and closely monitored.

Yet, even with such a team in place, Kenya's policy makers may choose not to promote reform. That is, the Kenyan leadership may “go through the motions” but not “own” the policy reforms. The practical effects of such an outcome are straight-forward. If Kenya is to improve its relative position in the world economy depends almost exclusively on the types of choices that its leaders make with respect to the promotion of rapid growth. From a global perspective, it is of little consequence what choices Kenya's leaders make -- Kenya's contribution to world welfare will remain small. An important question is whether the Kenyan leadership (government and opposition) can rise above local rivalries and intrigue to take the steps needed to stimulate and sustain broad-based improvements in the economy. Seen in this way, the question of “ownership” is moot. By their actions so far, Kenya's leaders have shown, that they do not want the country to grow and develop rapidly. The opportunity always exists for this change. Whether it will is an open question. Kenya’s history is not encouraging; but, one can hope that broader national goals will someday prevail.

5. Concluding Comments

In Kenya, it may be true that the exchange rate has reduced the economy's growth potential. The analysis in this paper, however, suggests that the roots of the problem of slow growth lie elsewhere. The present structure of the macro-economy and the way it is managed does not inspire confidence among the local and foreign business community. In particular, they do not see that: a. economic reform will be vigorously pursued; b. that the high costs of "doing business" in Kenya because of generalized inefficiency and corruption will decline in the foreseeable future; and c. that the government is fundamentally committed to promoting sustained growth and development. Moreover, despite the government's statements about reducing the role of the public sector in the economy, it remains too large, too inefficient, and too intrusive.

Local and foreign private businesses which could make a major difference to Kenya's growth prospects remain marginalized. Relative to other countries in Africa, the Kenyan economy has shown evidence of stability, even if that is punctuated with periodic “blow-outs”. Nonetheless, it is held back by the general expectation that the situation will not improve substantially. Without a
dramatic shift of policies by the government, there will be major "shift in sentiment" by investors. Kenya's unspectacular economic performance is likely to continue.

The remedy to this situation, which has been known and written about for many years, is comprehensive, constructive and rapid economic reform. Improvements in exchange rate management can make a difference to growth prospects as part of the context of a broader program of adjustment and reform. To be effective, that program would focus on the elimination of the public sector deficit, the sharp down-sizing of the government, the rapid sale or closure of public enterprises, and increasing openness and transparency as a means of reducing the dead-weight of patronage and corruption.

Kenya is now well into its second decade of attempting to promote economic reform. Few of the programs in the past worked largely because of continued public intervention that prevented them from working. The time has long passed for that to change. Exchange rate and financial policies more generally would be a useful place to start. However, if rapid, sustained growth is to be achieved in Kenya the economic reforms have to be far more comprehensive and persistent than anything yet attempted.
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Endnotes

1. Both the Sessional Paper No. 1 of 1986 "Economic Management for Renewed Growth" and Sessional Paper No. 1 of 1994 "Recovery and Sustainable Development to the Year 2010" have, as major goals, the revival and maintenance of high rates of growth.

2. Ramakrishnan 1997


6. “The Economic Consequences of Mr. Churchill”. This was written in 1925 after the government, with Winston Churchill as Chancellor of the Exchequer, had prevailed upon the Bank of England to re-establish the old parity between the pound sterling and gold (Keynes 1931).

7. Eichengreen and Sachs 1985:936-939

8. Johnson 1971; Triffen 1984

9. From 1978 to 1996 the growth in the European Union was 2.2 percent. By contrast, growth in all industrial countries over the same period has been on the order of 2.6 percent (IMF 1996:Table A.1, p. 167).


11. Sachs, Tornell and Velasco 1996


13. Johnson 1966; OECD 1994; ILO 1996:75-79. This point was also made by Triffen (1947) in the context of central bank management of international financial flows.

14. Experience in OECD countries with structural adjustment (OECD 1994) is that delayed reform is ultimately more costly directly (through the cost to the budget, the loss of international reserves, rising debt) and indirectly (through the loss of output and employment, and declining confidence). The same lesson is evident in developing countries (McPherson and Radelet 1995; Demery and Squire 1996; McPherson 1996).


17. Kindleberger 1989; Friedman 1992

18. Leaving aside the hyperinflations in Hungary, Germany and Austria (in the aftermath of WWI), the situation in the 1920s and 1930s in Europe is distinguished from the events of the 1970s and 1980s in Africa in at least one important
The European governments made an explicit choice between devaluation and deflation as a means of correcting macroeconomic imbalances which arose from currency over-valuation (Keynes 1931:186-212). By contrast, African countries have resisted both devaluation and deflation for many years. Excessive local and foreign borrowing eventually forced precipitous currency realignments and some dramatic price increases. For instance, in Zambia, the exchange rate moved from K.65=$1 in 1974 to K1280=$1 in 1996 while the price level (measured as 1990=100) moved from 1 to 4925. The Kenyan situation has not been as dramatic. The exchange rate was Ksh7.1=$1 in 1974 and by 1996 it was Ksh57.1=$1. Over the same period, consumer prices in Kenya increased by a factor of 20.5 (Source: International Financial Statistics various issues).


20. Sachs and Larrain 1993:297-300

21. The demand for money can be written as domestic prices multiplied by a function of real income and interest rates. For a fixed exchange rate, any excess demand for (supply of) money will be reflected as the accumulation (depletion) of international reserves. For a floating exchange rate, any excess demand for (supply of) money will lead to an appreciation (depreciation) of the exchange rate. These portfolio changes directly influence domestic prices. Under a fixed exchange rate, excess demand for (supply of) money reduces domestic demand thereby reducing (increasing) the rate of inflation. These changes in prices will, respectively, under-value (over-value) the real exchange rate. With a floating exchange rate, the domestic price changes will lead to movements in the exchange rate. Due to the existence of lags, uncertainty as to the permanence of policy changes, credibility effects and so on, the above adjustments in practice will not occur smoothly. The above effects, however, are relatively consistent over the medium terms (Johnson 1973: Ch.9; Sachs and Larrain 1993:299-301; and Rogoff 1996).

22. Maciejewski 1983; Helmers 1988

23. Variations in the estimates of real exchange rate can arise in several other ways. Examples are the inclusion of taxes and subsidies and estimates for restrictions on trade and the estimation of sectoral or industry-based real exchange rates (Roemer and Stern 1981:204-211: Meier 1989:491-494).


25. Prices are typically mis-aligned in two ways. In static terms, the comparative costs of production and distribution at the existing real exchange rate are “too high” in the sense that the underlying economic “absorption” generates a balance of payments deficit which cannot be financed. In dynamic terms, some behavior emerges (such as persistent deficit financing) which tends to raise the rate of overall domestic inflation above the corresponding rates in the country’s main trading partners. In the former case, the real over-valuation can be corrected by a devaluation which leads to “expenditure-switching” and “demand-reduction”. In the latter case, the real over-valuation requires a change in the behavior that leads to excess money creation combined with a floating exchange rate, or a pre-determined, credible, “tablita” which regularly offsets the effects of the higher rate of domestic inflation.

26. Including South Africa makes no substantive difference to the conclusions. By world standards, SSA is a small economic unit. Its combined GDP is just above one percent of world GDP. Nineteen separate countries (and some states within large countries) have larger output and income.

27. In 1980, SSA’s external debt was $84.1 billion, equivalent to 28.7 percent of GDP; in 1995, it was $226.5 billion, equivalent to 76.3 percent of GDP (World Bank 1997:Table 4.23, 4.2). The sharp rise in indebtedness is even more stark when allowance is made for the fact that South Africa (whose GDP is roughly one-third of SSA’s GDP) had minimal foreign debt.
28. Estimated GDP in SSA in 1980 was $292.6 billion and $296.7 billion in 1995 (World Bank 1997:Table 4.2). Over the same period population in SSA increased from 381 to 583 million (ibid.:Table 2.1). Thus, in dollar terms, average per capita income declined by 33.7 percent.

29. Labor force growth for the periods 1980-90 and 1990-94 were, respectively, 2.8 and 2.7 percent per annum (World Development Report 1996: Table 4). The growth rate over the whole period 1980-95 was 2.7 percent (World Bank 1997:Table 2.3).

30. Exports of goods and services from SSA in 1980 were estimated to be $90.1 billion; in 1995, they were $89.6 billion (World Bank 1997:Table 4.21).

31. In the 1950's and 1960's the share of world exports from SSA exceeded 3.5 percent (Svedberg 1991; Yeats et al. 1997). Recent estimates put that share at around 1.4 percent (World Bank 1995:73; World Bank 1997:Table 4.21).

32. Imports of goods and services in 1980 were $84.2 billion; in 1995, they were $98.6 billion (World Bank 1997:Table 4.21). This implies a 23.5 percent decline in the dollar value of imports per capita over the 15-year period. Since imports in 1994 were $100.7 billion, the 1995 total represented a 4.5 percent real decline from 1994 (World Bank 1996:Table 12).

33. Official development assistance as a percent of GNP in SSA was 3.4 in 1980, 13.3 in 1990, and 16.3 in 1994 (World Bank 1996: Table 3; 1997:Table 6.10).

34. World Bank 1997:Table 5.2

35. World Bank 1997:Table 5.5

36. The total debt of SSA in 1995 was $226.5 billion, a rise of 6.2 percent relative to 1994 (World Bank 1997:Table 4.3). Many countries are still borrowing (albeit on concessional terms) to service their foreign debt. Some heavily-indebted countries continue to run up short-term suppliers' credit backed by commodity guarantees, or prospective privatization receipts.

37. An illustration of scale is important. In early 1997, the average daily turnover on the major foreign exchange markets was around $1.5 trillion. The corresponding datum for the Johannesburg market, which is the largest in Africa, was around $7 billion (Stals 1997). A further indication of the marginalization of SSA is provided by data on foreign direct investment (cf. UNCTAD data ADB 1997:Table 1.8 and World Bank 1997:Table 5.2). Over the period 1984-89, SSA received on average 6.6 percent of the annual flow of U.S. $22.2 billion of FDI to all developing countries. From 1990 to 1995, the share was only 2.9 percent.

38. World Bank 1997:Table 4.1

39. World Bank 1997:Table 4.20; ADB 1997: Tables 1.3, 1.5,1.6

40. Data from World Bank (1997: Tables 2.1, 4.1, 4.2, 4.20, 4.21, 4.23, 4.24, 6.10) show the following for Kenya.

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (millions)</td>
<td>17</td>
<td>27</td>
</tr>
<tr>
<td>GDP (US $ millions)</td>
<td>7265</td>
<td>9095</td>
</tr>
<tr>
<td>Exports of Goods/Services ($mn)</td>
<td>2007</td>
<td>2949</td>
</tr>
<tr>
<td>Imports of Goods/Services ($mn)</td>
<td>2846</td>
<td>3524</td>
</tr>
<tr>
<td>Official Aid (% of GNP)</td>
<td>5.6</td>
<td>9.7 (1994)</td>
</tr>
<tr>
<td>Foreign debt ($ millions)</td>
<td>3383</td>
<td>7381</td>
</tr>
<tr>
<td>Debt Service (% of Exports)</td>
<td>21.6</td>
<td>25.7</td>
</tr>
<tr>
<td>Net Private Capital Inflow($ mn)</td>
<td>10</td>
<td>-42</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>----</td>
<td>-----</td>
</tr>
<tr>
<td>Budget surplus/deficit (% GDP)</td>
<td>.6</td>
<td>-2.3 ('93-95)</td>
</tr>
<tr>
<td>Growth of real GDP 1980-90</td>
<td>4.2</td>
<td></td>
</tr>
<tr>
<td>Growth of real GDP 1990-94</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>Annual inflation 1980-90 (%)</td>
<td>11.1</td>
<td></td>
</tr>
<tr>
<td>1990-95 (%)</td>
<td>27.3</td>
<td></td>
</tr>
</tbody>
</table>

41. Between 1980 and 1994, the Kenya shilling depreciated by 86.7 percent in nominal terms (from K Sh7.42=$1 to K Sh56.1=$1). The real depreciation was 39 percent. Between 1994 and 1996, the nominal depreciation was .8 percent. However, in real terms the shilling appreciated by 33.7 percent. Even the recent disturbances have not led to a sharp depreciation. The internet quote (“164 Currency Converter”) on 8th October was KES61.55=$1. The May rate was KES53.79=$1 (IFS July 1997:403), which represents a nominal depreciation of 12.6 percent.


43. While this gap has only become positive in Kenya over recent years, in mature financial systems such as the United States and the United Kingdom, the gap has been positive continuously. Over the period 1990 to 1996, it averaged 3.9 percent per annum in the United Kingdom and 1.5 percent per annum in the United States. Neither the U.S. nor the U.K. experienced financial disintermediation. This was not the case in Kenya.

44. Data provided by Graham Glenday which are derived from Central Bank of Kenya sources show that savings over the period 1989 to 1996 averaged 15.4 percent of GDP.


46. IEA 1994:75-79

47. Many of these have been highlighted in Agenda ’94 People, Economic Affairs & Politics (1994). A basic theme of the report is the intrusiveness and overall inefficiency of the public sector.


49. Drought in Africa can be devastating. But, it stretches the point to continue arguing, as most African governments do, that droughts represent "exogenous shocks". Drought is a recurrent phenomenon. As a matter of prudence and good management, its effects should be explicitly included by governments in their budgets and contingency plans (Glantz 1989). Typically, this does not occur.

50. This applies to the repatriation of flight capital as well as the attraction of “new” foreign direct investment.

51. Kenya, like most countries in SSA, has moved away from the situation which prevailed when large international aid flows first began. At that time, the goal was economic growth (defined as rising real GDP per capita) through “self-help”. Aid, it used to be believed, should complement local development efforts not substitute for them (Goldwin 1963; USDS 1964; Ohlin 1966). There were many reasons -- political, administrative, and institutional -- why this approach was abandoned. The outcome has been that both the donors and the aid recipients are enmeshed in a pattern of aid dependence that has resulted in low growth and minimal development (Johnson 1997).

52. Worse, the prospect of continued aid to Africa make comprehensive economic reform unattractive for most governments. Achieving a sustained reduction in aid would require decisions with respect to economic management that may have unpopular effects. It is interesting to contrast the differences in the effect of aid on growth in Asia and Africa
Over the last three decades, the amount of aid relative to GDP in most Asian countries has been low, yet most Asian countries have grown rapidly and recorded broad-based improvements in general welfare (Stiglitz 1996). Over the same time period, most African countries have received large inflows of aid both in absolute and relative terms. Growth has been low and most welfare indicators have deteriorated (GCA 1996; ADB 1997; World Bank 1997).

53. See, for example, IEA 1994:114-123; Ramakrishnan 1997

54. Over the last several years, Kenya has undertaken a wide-ranging reform of its tax system. This has removed many of the most costly distortions (Glenday 1995). However, due to these reforms the government has been able to maintain its high share of expenditure. Ideally, the tax reform should have enabled the government to scale back its operations by progressively lowering of the share of GDP which it raises and spends. This approach was successfully followed, for example, in The Gambia (McPherson and Radelet 1995: Chs. 9,17). It has also been essential to the success of New Zealand's economic recovery (Evans et al. 1996).


56. World Bank 1997:Table 4.12. In 1980 gross domestic saving and gross domestic investment in SSA were respectively 27 and 23 percent of GDP. Corresponding data for 1995 were 16 and 19 percent. By contrast, GDS and GDI in East Asia and the Pacific were, respectively, 28 and 28 percent in 1980. Corresponding data for 1995 were 38 and 39 percent.

57. Kaldor 1963; Meier 1970:190-209. At one time, development economists promoted the idea of “government as saver”. It was passed over as most governments (with exceptions such as Singapore and Botswana) began running large deficits on a continuous basis. Recent work has revived the idea in the context of restarting growth in Africa (Sachs 1996; HIID 1997).

58. Sessional Paper No. 6, 1996:Ch.3; IMF 1997; Ramakrishnan 1997

59. The reaction by Western governments to the killing of students by Kenyan troops and the closure of the university at the beginning of July 1997, led to (yet another) outburst by President Moi about foreign meddling.

60. Leaders in Kenya, like others throughout SSA, have tended to believe that adjustment would be unnecessary, or less demanding, if only the rest of the world would change in convenient ways. Commonly mentioned changes are the provision of larger aid flows, fewer conditions attached to foreign aid, the forgiveness of external debt, and subsidized prices for exports. In effect, Kenya’s leaders expect the rest of the world to accommodate their country's imbalances. This position has been prominent in the work of the Organisation of African Unity and the Economic Commission for Africa (OAU 1980; United Nations 1986; ECA/OAU 1989). The reality, however, is that the Kenyan economy has to adjust. The only question is whether the adjustment will be systematic (through a formal program in which the government acts constructively) or ad hoc through the continued decline in real per capita incomes (Lewis and McPherson 1994).

61. Bevan, Collier and Gunning (1989) examined how the windfall receipts from the coffee boom in the mid-1980s were mis-handled. At that time, the government had the resources needed to allow the economy to adjust in a non-disruptive fashion. Instead, the windfall was used to expand government expenditure in a manner that could not be sustained once coffee prices fell. Asea and Reinhart (1996) analyze the same phenomenon in other countries.

62. When investments have large fixed costs, entrepreneurs have an incentive to wait (Pindyck 1991; Hubbard 1994; Severn 1996). This allows them time to collect more information, and for some of the more obvious risks (such as policy reversals by the government) to diminish.

63. This was written in May 1997 before the disruptions which followed the civil unrest and the financial turmoil in
Asian markets. These events reinforce the point about the constraints imposed on the government's policy options by the choices made by local and foreign asset-holders. The recent movements in the exchange rate of the shilling is symptomatic of a major shift in confidence. A number of leaders have been outspoken about what they see as problems created by “hot money” and threatened to reimpose controls. That would be a retrograde step. The pressing need is prudent economic management, not controls.

64. Price stability has been a key issue on the agenda of most central banks for almost two decades. (One group argues that price stability is the only relevant goal for a central bank, cf. Stern 1996.) With low inflation throughout the members of the OECD, most central banks have turned their attention to the maintenance of price stability. There are many proposals. One condition which is universally acknowledged is that governments have to reduce their budget deficits to levels which are consistent with price stability. Without this, no commitment to price stability by any central bank can be credible (King 1996:30; Mishken and Posen 1997). The importance of government “self-restraint” in this regard New Zealand’s (NZ) experience over the last decade. Its rate of inflation has fallen sharply. According to many observers, this is due to the “independence” of the central bank. Some autonomy may be important, but a point which is rarely noted is that, prior to the time the NZ gave the Reserve Bank its independence, it ceased running deficits (IFS Yearbook 1996:580-581; Evans et al. 1996).

65. The volumes which have been written on the credibility of policy and reputation underscore the importance of the standard goals of budgeting -- efficient allocation, equitable distribution, and stabilization (Kaufman 1989:Ch.26; Gillis et al. 1996: Ch. 20; Ramakrishnan 1997a). This point is especially relevant to SSA where budgets are largely framed using alternative criteria such as appeasing the civil service, placating particular constituencies, generating “slack” which can be diverted for private or “party” purposes, or subsidizing value-subtracting State-Owned Enterprises.

66. No other country ever has. An obvious example is Mexico which experienced a major melt-down in 1994 due to the perceptions by local and foreign investors that the government's budget was unsustainable. The recent problems in Thailand and Malaysia have the same roots.

67. A reviewer of this paper commented: “...large deficits are bad and unsustainable but small deficits are often considered good enough”. This view, which is all too common in Kenya, partly symbolizes one of Kenya’s main problems. Sloppy management which does not “rock the boat” or require “too much” discipline is considered “good enough”. In reality, however, Kenya's “good enough” approach to budget management is far from what is required to promote high, sustained rates of growth and development.

68. A number of articles have appeared (Anand and van Wijnbergen 1989; van Wijnbergen 1989), based on the view that deficits in developing countries are “sustainable”. As an example, these authors use Turkey, a country which has never been known for its macroeconomic stability or history of sustained growth and development. It is noteworthy that a significant portion of the real resources required to “sustain” the deficit come from “seignorage” and the “inflation tax”. Most analyses of these phenomena in the literature are wrong (McPherson 1997 provides a critique). In practical terms, developing countries which intend growing rapidly over the long term should discard the idea that deficits can be sustained.


70. This is not a new policy direction. It would simply make effective the measures to which the government is already committed (Sessional Paper No. 2 of 1996:24-27).

71. Sessional Paper No. 2 of 1996:23-24; Le Monde 15 July 1997:7; Le Figaro 19-20 July 1997:3; The Economist 9th August, 1997:38. The suspension of donor assistance in 1991 gained impetus from the Danes who were frustrated with corruption among senior government officials and the lack of accountability within the public sector. The Boston Globe (30th July 1997:3) noted that, in order to reach agreement on a program with the IMF, the Government of Kenya had
made a commitment to take special measures to reduce corruption. Such an explicit public admission of the problem is rare!

72. The studies in IRIS (1996) outline the negative effects of corruption on growth and development in a number of countries in SSA. The problem is deep-rooted, generic, and virtually unaddressed. By draining resources from SSA, it makes rapid growth and development impossible.

73. Two recent examples are IEA (1994) and the Sessional Paper No. 6 of 1996, pp.iv, 21,23

74. Obviously, union leaders will object. Nonetheless, as experience in both rich and poor countries has shown, economic decline begins to undermine the ability of unions to obstruct reform. The argument that the government will never abandon such a "key" constituency as labor, which has been common in South Africa since 1994, is confirmation that economic reform is not a priority.

75. A typical way in which labor unions have delayed the restructuring of the public sector has been through the negotiation of exorbitant redundancy packages. Governments are then faced with the choice of attempting to fit these payments into budgets which are already over-stretched, or of allowing reform to lapse. One way out of this dilemma is to create the equivalent of a ministry of redundancy. All workers who are not needed to staff a radically smaller public service would be transferred to this "ministry". They would continue to draw their base pay but not be required to work. At current rates of interest throughout SSA, the present value of retaining redundant workers is significantly below the costs of meeting the redundancy payments, a large part of which is a lump-sum cash payment.

76. See, for example, the approach to macroeconomic management outlined in Sessional Paper No. 2 of 1996, Chapters 1 and 3.

77. With appropriate macroeconomic management, the international economy also provides many growth-enhancing opportunities (IMF 1997). Yet, none of these can be important for growth until the government makes an effective commitment to restore and sustain macro-economic balance.

78. In light of the minimal share of Kenya (and SSA) in world-wide financial flows (referred to earlier), policy makers could usefully reflect on: a. why Kenya's share is so low?; and b. what could be done to raise it? By attempting to answer these questions, Kenyan officials will begin to highlight some of the elements which continue to marginalize Kenya (and SSA) within the global economy.

79. African countries, as a group, have made some important progress in reducing inflation (ADB 1997: Ch. 1). So has the rest of the world. Thus, even though African inflation has fallen it remains unacceptably high. By current world standards, recent rates of inflation of roughly 10 percent indicate that, relative to the rest of the world, the fiscal and monetary situation in Kenya is still “out of control”.

80. Attempts to understand more about the issue of sustained reform are being made by U.S.-based and African scholars under the US AID-funded project “Restarting and Sustaining Growth and Development in Africa”. This HIID-led study is being conducted under the auspices of the project Equity and Growth in Africa through Economic Research/Public Strategies for Growth with Equity (EAGER/PSGE).

81. But, having such a team is no guarantee that appropriate policies will continue to be implemented. As developments in Zambia since mid-1995 have shown, the key policy makers can readily ignore the general recommendations of such a technical committee, even when these recommendations remain relevant to sustained reform.

82. Comments on an earlier draft of this paper referred to the many improvements which Kenya has been making. As already noted, some of the changes have been impressive. The problem, however, is that the rest of the world has stabilized far more rapidly than Kenya has, and the rest of Africa generally (ADB 1997:Table 1.3). Thus, though its policies have been improving, Kenya was not gaining relative to the rest of the world. In this respect, Kenya’s policy
makers have to recognize that their history is not the only benchmark in assessing performance.


84. These high growth rates have continued. Data kindly supplied by Graham Glenday drawn from Central Bank of Kenya sources show that the June ‘96 to June ‘97 increase in M2 was 17.5 percent. The corresponding increase for M3 was 10.2 percent. For a country that is not undergoing any substantive financial deepening and growing at less than 5 percent in real terms, this rate of monetary growth is inconsistent with macroeconomic stability.

85. None of the developed countries, which all have far deeper financial systems and far more capable central banks than Kenya, can re-fix or “manage” their exchange rates effectively. At times, policy makers may be frustrated with the direction of change in market-determined exchange rates. The source of the problem, however, is typically with other aspects of economic policy -- such as the budget deficit or money creation -- not the functioning of the exchange rate market as such.

86. Duesenberry and McPherson 1991

87. In Zambia, the government took advantage of a sharp reduction in interest rates accompanying the introduction of the cash budget to begin lowering the minimum reserve requirements and paying interest on all reserves above the new minimum of 5 percent. The immediate effect was to reduce the interest rate spread. The program worked well until the Bank of Zambia and the Government began to reverse the key economic reforms. In Kenya, the spread between the overdraft rate and the savings rate is approximately 18 percentage points. Such a spread deters saving and discourages investment.

88. In 1995, Kenya had .46 percent of world population, engaged in the equivalent of .05 percent of world trade, and generated .03 percent of world income (World Bank 1997:Tables 2.1, 4.2, 4.21).
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